Memorandum 190.2835

To: Mr. Glenn Bystrom
Principal Tax Auditor

Date: January 31, 1992

From: John L. Waid
Tax Counsel

Subject: [S] Corporation
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Assistant Chief Counsel Gary J. Jugum has tasked me to respond to your memorandum to him of December 18, 1991, regarding the above matter.

I. FACTUAL BACKGROUND

> "The Hollywood District Principal Auditor has referred an inquiry from [S] corporation to me for reply. [S] has asked us to determine if a contract they have with the [L] would qualify as a fixed price contract under Section 6376.1. The contract [#] dated September 1, 1987) calls for [S] Corporation to provide 54 light rail vehicles and related spare parts and tools to the [L]. Some spare parts and special tools were sold under this contract at the end of September 1991.
>
> "Attached to Hollywood's memo was the [S] Corporation's inquiry and the following documents: (1) an acknowledgement memo from [E] services to [S] regarding Contract No. [#] (2) Contract Change Order #20, regarding a 0.25 percent sales tax rate increase, (3) performance bonds, and (4) Conformed Contract Documents, Volume – II, Contractual Requirements.
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> "In their memo, the Hollywood District Office states that, the total contract price is $69,607,934, including 6.5 percent california tax. However, under the attached Contract Requirements Section CP 6.0, "Economic Price Adjustments," [S] is allowed to adjust the price for the light rail vehicles and the spare parts. This section describes a formula to be applied quarterly, adjusting the contract upward or downard for changes in current labor indices and current material indices, as published in Employment and Earnings and Monthly Labor Review, publications of the U.S. Department of Labor, Bureau of Labor Statistics."

Unfortunately, Hollywood did not send any of the paragraphs of the contract that deal with the conditions under whhich the contract may be terminated. We will assume for the purposes of this letter that the contract may be terminated only for cause and the [L], if it is the terminating party, must pay [S] for any work it had done up to the date of termination. This is a

safe assumption as such clauses are typically included in such contracts. I understand, by the way, that Hollywood sent all of the documents which it got from [S].

Regarding payment of taxes, the contract required as follows:

"CP 4.4 Payment of Taxes

> The Contractor shall pay all sales, income, real estate, transportation, export, import and other taxes and duties which are applicable to the Cars and other materials and work performed under the Contract and are legally enacted at the time bids are received. The Contractor shall secure and pay for all permits and governmental fees, licenses and isnpections necessary for the proper execution and completion of the Contract."

The documents which Hollywood sent regarding Change Order #20 given an indication of how the parties interpreted the above clause. Hollywood's memo indicates that this Change Order, which added .25% to the sales tax rate specified in the contract due to the temporary tax increase under the "Earthquake Tax," was executed because the parties agreed that the contract was not exempt from that tax. The Contract Change Order dated February 9, 1990, describes the reason for the change order as follows:

> "Effective December 1, 1989, the rate of Sales Tax in California was increased by one-quarter percent as a result of the new earthquake relief fund. (In Los Angeles County, the tax rate therefore increased from 6.50% to 6.75%.) Accordingly, effective with the sale of LRVs and other tangible personal property under the Vehicle Contract on or after December 1, 1989, the sales tax due thereon will increase from 6.50% to 6.75%.
>
> Under Paragraph CP 4.4 of the Contract, [S] is required to pay Sales Tax applicable to the LRVs, other materials and work performed that is <u>legally enacted at the time bids are received</u> [emphasis added], i.e., 6.50%. Accordingly, under the terms of the Contract, a Change Order is required to add the 0.25% tax due to the State of California."

The [L] Record of Negotiations, also dated February 9, 1990, discussed the change order negotiations as follows:

> "The Change Notice covered by this Change Order was discussed at several informal meetings among [S], [L], and [E]. <u>As the Contract was clear on this matter, it was not subject to any negotiations</u>. [E] was directed by [L] to prepare a Change Order documenting [L]'s <u>responsibility to remit the additional one-quarter percent sales tax</u> to [S] for their payment to the State of California for all

> light rail vehicles and other tanigble property delivered and accepted under this contract after November 30, 1989. [Emphasis added.]
>
> This arrangement will remain in effect as long as the emergency sales tax is itself in effect."

The contract documents do not include a page showing the date of the contract. The Performance Bond, dated May 14, 1987, states, however, that the contract had already been awarded when the former was executed.

Although Hollywood's memorandum does not say, we assume that the sale of spare parts and tools was one of the provisions of the original contract and so is not a change order executed after July 15, 1991, although the sale took place after that date.

You indicated that a member of your staff had previously discussed this matter with Senior Tax Counsel David H. Levine who had opined that this contract did not qualify as a fixed-price contract. You ask if it could still be recognized as being for a fixed price when the increases for costs of materials and labor are tied to government price indices.

II. OPINION

A. Fixed Price Contracts Generally

In determining whether a contract is a "fixed-price" contract we have consistently required that it satisfy the following criteria: (1) it be binding prior to July 15, 1991, (2) neither party has an unconditional right to terminate that contract; (3) the agreement msut fix the amount of all costs at the outset; and (4) the agreement must include a provision which fixes the tax obligation on a tax-included basis or sets forth either the amount or the rate of tax and does not provide for an icnrease in the amount of tax.

B. Tax Consequences to [S] Corporation

Under our assumptions, this contract clearly satisfies the first two criteria. It was binding prior to July 15, 1991, and it only provides for termination upon default. The issues here are the last two criteria. Does the fact that [S] reserves the right to increase its charges for labor and materials based on cost increases as measured by the Current Labor Indices and Current Material Indices put out by the Department of Labor means that the contract price is not fixed ab initio? Or does the Payment-of-Taxes clause indicate that [S] has reserved the right to pass on tax increases to the purchaser – i.e., [L]?

We think the contract fails on both counts. First, Paragraph CP 4.4 quoted above indicates that [S] agreed to absorb only those taxes in effect on the date that bids for the contract

were received (presumably late 1986 – early 1987). The documents plainly show that both [S] and [L] agreed that this clause required [L] to be responsible for any and all taxes enacted subsequent to the date that the bids were received. As [L]'s own Record of Negotiation states, "the contract was clear on this matter, it was not subject to any negotiations." [L] thus had to reimburse [S] for the extra tax it had to pay has a result of the "earthquake tax." As [S] reserved the right to pass on tax increases to [L], the contract does not qualify as being for a fixed price.

Second, [S] reserved the right to pass icnreases in costs of labor and materials on to its purchaser, [L]. As noted above, in order for a contract to be considered as beeing for a fixed price, the price must in fact be fixed at the outset with no room for increases. The instant contract is not actually for a sum certain but rather for a sum certain plus cost increases. This rule is set forth in Former Regulation 1521.5(c)(6) which states as follows: "A contract is not for a 'fixed price' if it … provides for increasing the amount of the contract by reason of increases in the costs of materials or labor." Although this regulation has long since been repealed, we have continued to follow the policies set forth therein. The fact that the formulae contained in the contract to determine what the icnrease should be do not appear to leave room to play with the increase so as to disguise a tax increase is immaterial. It is the availability of the increases which dooms this contract. An obligation which can be varied is by definition not "fixed." Therefore, we must confirm our opinion as previously passed on to your staffer by Mr. Levine.

JLW:es